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**COORDINATED ISSUE
MAQUILADORA INDUSTRY
I.R.C. § 168(g)(1)(A)**

U.S. entities that own or use maquiladoras in Latin America can transfer tangible property to the maquiladora plant for use in the assembly process. This property is transferred without incurring any export or import customs duties and title to the property remains in the U.S. entities' name.

ISSUE

What is a U.S. entity's depreciation deduction for tangible property transferred to a maquiladora located in Latin America?

FACTS

The U.S. entity transferred tangible property to a maquiladora in Latin America to be used in the maquiladora's assembly operation.

None of the property is described in I.R.C. § 168(g)(4), which excepts certain property used outside of the U.S. from I.R.C. § 168(g)(1)(A).

The U.S. entity computed depreciation using an accelerated method.

The property was used predominantly outside the U.S. (physically located outside the U.S. during its use for more than 50% of the time) during the taxable year.

LAW and DISCUSSION

Method of Computing Depreciation Deduction

Generally, I.R.C. § 168(a) allows U.S. persons to use the general depreciation system (the accelerated methods of I.R.C. § 168(b) and the short recovery periods of I.R.C. § 168(c)) for tangible property except where otherwise provided in I.R.C. § 168. I.R.C. § 168(g)(1)(A) provides, in general, that in the case of any tangible property that during the taxable year is used predominantly outside the U.S. the depreciation deduction provided by section 167(a) shall be determined under the alternative depreciation system (I.R.C. § 168(g)(2)). Under the alternative depreciation system, depreciation is determined by using--

- (A) the straight line method (without regard to salvage value),
- (B) the applicable convention determined under section 168(d), and
- (C) a recovery period determined under the following table:

In the case of:	The recovery period shall be:
(i) Property not described in clause (ii) or (iii)	The class life.
(ii) Personal property with no class life	12 years.
(iii) Nonresidential real and residential rental property	40 years.
(iv) Any railroad grading or tunnel bore	50 years.

Under the legislative history to this section, property that is used outside the United States for more than half of a taxable year is deemed to be used predominantly outside the United States. S. Rept. No. 313, 99th Cong., 2d Sess. 103 (1986). This is further supported by Rev. Rul. 90-9, 1990-1 C.B. 46, which provides that to determine whether property is used predominantly outside the United States, section 168(g) applies rules similar to those under former section 48(a)(2). Under that section and regulations pertaining thereto, property located outside the United States for more 50 percent of the year was considered to be used predominantly outside the United States. Treas. Reg. § 1.48-1(g)(1)(i); Norfolk Southern Corp. v. Commissioner, 104 T.C. 13, 43 (1995).

Since the U.S. entity used the tangible property outside the U.S. for more than half of the taxable year, it is deemed to have been used predominantly outside the U.S., and therefore the entity is required to compute its depreciation deduction under the alternative depreciation system provided in I.R.C. § 168(g)(2). Rev. Proc. 87-56, 1987-2 C.B. 674 and Rev. Proc. 88-22, 1988-1 C.B. 785, set out the class life referred to in section 168(g)(2). It is important to verify that the taxpayer used the correct class life.

POSITION

The U.S. entity must compute the depreciation deduction under the alternative depreciation system contained in I.R.C. § 168(g)(2) for any tangible property that

during the taxable year is used predominantly outside the U.S. and that is not described in section 168(g)(4).

Change in Method of Accounting

For an item of depreciable property that is used predominantly outside the U.S., a change from the general depreciation system (the accelerated depreciation method of I.R.C. § 168(b) and the short recovery periods of I.R.C. § 168(c)) to the alternative depreciation system of I.R.C. § 168(g)(2) may be a change in method of accounting to which the provisions of I.R.C. §§ 446 and 481 apply.

If a U.S. entity that was properly depreciating property under the general depreciation system transfers the property from the U.S. to a maquiladora that uses the property predominately outside the U.S., a change in use of the property occurs. If the U.S. entity begins to use the alternative depreciation system of I.R.C. § 168(g)(2) for this property the first year the property is used predominantly outside the U.S., no change in method of accounting is required because of this change in use.

However, if the U.S. entity continues to use the general depreciation system for the property, the U.S. entity is using an erroneous method of accounting for depreciation of the property. Generally, a change from this erroneous method for depreciation to the alternative depreciation system of I.R.C. § 168(g)(2) for a year after the first year the property is used predominantly outside the U.S. is a change in method of accounting to which the provisions of I.R.C. §§ 446 and 481 apply. However, no change in method of accounting occurs if the U.S. entity uses the general depreciation system for the property for the first year the property is used predominantly outside the U.S. and, before filing the tax return for the next year, the U.S. entity files an amended return for the first year the property is used predominantly outside the U.S. using the alternative depreciation system of I.R.C. § 168(g)(2) for the property. See Rev. Rul. 72-491, 1972-2 C.B. 104.

If there is a change in method of accounting, the net adjustment required under I.R.C. § 481(a) is computed as of the beginning of the year of the change in method of accounting. The positive section 481(a) adjustment (increase in income) is computed for property on hand as of the beginning of the year of the method change and is the difference between:

- (a) the total amount of accelerated depreciation (as determined under I.R.C. §§ 168(b),(c), and (d)) for the depreciable property taken by the U.S. entity for years beginning with the first year the property was used predominantly outside the U.S. and before the year of the change in method of accounting, and

- (b) the total amount of depreciation allowable for the depreciable property under the alternative depreciation system (as determined under I.R.C. § 168(g)) to the U.S. entity for years beginning with the first year the property is used predominantly outside the U.S. and before the year of change in method of accounting.

The amount of the positive § 481(a) adjustment, however, must be adjusted for any corresponding change in the depreciation amount that is required to be capitalized by the U.S. entity under any provision of the Code (for example, capitalized to the cost of the U.S. entity's inventory under § 263A).

A change in method of accounting, as described above, that is made by the District Director as part of an examination of the taxpayer's return(s) will ordinarily be made in the earliest taxable year under examination or, if later, the first taxable year the property was used predominantly outside the U.S. Further, the entire amount of the positive section 481(a) adjustment is ordinarily included in the District Director's computation of the taxpayer's taxable income for the year of the method change. See section 2.10 of Rev. Proc. 97-27, 1997-21 I.R.B. 10 (May 27, 1997).